

**MICHIGAN SOUTH CENTRAL
POWER AGENCY**

Litchfield, Michigan

FINANCIAL STATEMENTS

June 30, 2008 and 2007

Auditing Procedures Report

Issued under P.A. 2 of 1968, as amended and P.A. 71 of 1919, as amended.

Local Unit of Government Type <input type="checkbox"/> County <input type="checkbox"/> City <input type="checkbox"/> Twp <input type="checkbox"/> Village <input checked="" type="checkbox"/> Other		Local Unit Name Michigan South Central Power Authority	County Hillsdale
Fiscal Year End June 30, 2008	Opinion Date August 21, 2008	Date Audit Report Submitted to State September __, 2008	

We affirm that:

We are certified public accountants licensed to practice in Michigan.

We further affirm the following material, "no" responses have been disclosed in the financial statements, including the notes, or in the Management Letter (report of comments and recommendations).

- YES ☒ NO ☐ Check each applicable box below. (See instructions for further detail.)
- ☒ ☐ All required component units/funds/agencies of the local unit are included in the financial statements and/or disclosed in the reporting entity notes to the financial statements as necessary.
 - ☒ ☐ There are no accumulated deficits in one or more of this unit's unreserved fund balances/unrestricted net assets (P.A. 275 of 1980) or the local unit has not exceeded its budget for expenditures.
 - ☐ ☒ The local unit is in compliance with the Uniform Chart of Accounts issued by the Department of Treasury.
 - ☒ ☐ The local unit has adopted a budget for all required funds.
 - ☒ ☐ A public hearing on the budget was held in accordance with State statute.
 - ☒ ☐ The local unit has not violated the Municipal Finance Act, an order issued under the Emergency Municipal Loan Act, or other guidance as issued by the Local Audit and Finance Division.
 - ☒ ☐ The local unit has not been delinquent in distributing tax revenues that were collected for another taxing unit.
 - ☒ ☐ The local unit only holds deposits/investments that comply with statutory requirements.
 - ☒ ☐ The local unit has no illegal or unauthorized expenditures that came to our attention as defined in the *Bulletin for Audits of Local Units of Government in Michigan*, as revised (see Appendix H of Bulletin).
 - ☒ ☐ There are no indications of defalcation, fraud or embezzlement, which came to our attention during the course of our audit that have not been previously communicated to the Local Audit and Finance Division (LAFD). If there is such activity that has not been communicated, please submit a separate report under separate cover.
 - ☒ ☐ The local unit is free of repeated comments from previous years.
 - ☒ ☐ The audit opinion is UNQUALIFIED.
 - ☒ ☐ The local unit has complied with GASB 34 or GASB 34 as modified by MCGAA Statement #7 and other generally accepted accounting principles (GAAP).
 - ☒ ☐ The board or council approves all invoices prior to payment as required by charter or statute.
 - ☒ ☐ To our knowledge, bank reconciliations that were reviewed were performed timely.

If a local unit of government (authorities and commissions included) is operating within the boundaries of the audited entity and is not included in this or any other audit report, nor do they obtain a stand-alone audit, please enclose the name(s), address(es), and a description(s) of the authority and/or commission.

I, the undersigned, certify that this statement is complete and accurate in all respects.

We have enclosed the following:	Enclosed	Not Required (enter a brief justification)	
Financial Statements	<input checked="" type="checkbox"/>		
The letter of Comments and Recommendations	<input checked="" type="checkbox"/>		
Other (Describe)	<input type="checkbox"/>	not applicable	
Certified Public Accountant (Firm Name) Virchow, Krause & Company, LLP		Telephone Number (608) 249-6622	
Street Address 10 Terrace Court		City Madison	State WI
		Zip 53707	
Authorizing CPA Signature	Printed Name Russ Hissom		License Number

MICHIGAN SOUTH CENTRAL POWER AGENCY

TABLE OF CONTENTS June 30, 2008 and 2007

Independent Auditors' Report	1
Management's Discussion and Analysis	2 – 7
Financial Statements	
Balance Sheets	8 – 9
Statements of Revenues, Expenses and Changes in Net Assets	10
Statements of Cash Flows	11 – 12
Notes to Financial Statements	13 – 33



INDEPENDENT AUDITORS' REPORT

To the Board of Commissioners
Michigan South Central Power Agency
Litchfield, Michigan

We have audited the accompanying balance sheets, statements of revenues, expenses and changes in net assets and cash flows of the Michigan South Central Power Agency (the Agency) as of June 30, 2008 and 2007, and for the years then ended. These financial statements are the responsibility of the Agency's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Michigan South Central Power Agency as of June 30, 2008 and 2007, and the changes in its financial position and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming opinions on the financial statements. The Management's Discussion and Analysis on pages 2 through 7 as well as the Schedule of Funding Progress on page 28 is not a required part of the financial statements but is supplementary information required by the accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Madison, Wisconsin
August 29, 2008

Virchow, Krause & Company, LLP

MANAGEMENT'S DISCUSSION AND ANALYSIS

MICHIGAN SOUTH CENTRAL POWER AGENCY

MANAGEMENT'S DISCUSSION AND ANALYSIS

June 30, 2008 and 2007

The management of the Michigan South Central Power Agency (the "Agency") offers all persons interested in the Agency's financial position this narrative overview and analysis of the Agency's financial performance during the years ending June 30, 2008 and 2007. Please read this narrative in conjunction with the accompanying financial statements and the accompanying notes to financial statements.

OVERVIEW OF THE FINANCIAL STATEMENTS

Michigan South Central Power Agency is a public body politic and corporate of the State of Michigan. The Agency was organized on March 21, 1978, under the authority of Michigan Public Act 448 of 1976, to supply electricity to member municipalities in south central Michigan. The Agency has five members: the Cities of Coldwater, Hillsdale, and Marshall; and the Villages of Clinton, and Union City.

This annual report consists of two parts: Management's Discussion and Analysis (this section) and the basic financial statements. These statements are prepared on the accrual basis of accounting in accordance with accounting principals generally accepted in the United States of America. The Agency uses the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission.

The Balance Sheet reports year end assets, liabilities and net asset balances based on the original cost adjusted for any depreciation, amortization or unrealized gains/losses as appropriate. The Statement of Revenues, Expenses and Changes in Net Assets presents information showing how the Agency's net assets changed due to the Agency's business activity. The Statement of Cash Flows reports the cash provided and used for operating activities, as well as other cash sources such as investment income and cash payments for repayment of bonds and capital additions.

AGENCY FINANCIAL ANALYSIS

Fiscal year 2008 was a busy year, operationally and financially. This year marked the third full year of Agency operations as a "Market Participant" in the Midwest Independent System Operator (MISO) Midwest Market Initiative energy market. This market, which commenced on April 1st, 2005, is meant to coordinate the provision of reliable, cost-effective energy. In 2008, the Agency received a net credit from MISO market charges of approximately \$44,000, while in 2007 the Agency received a net credit from MISO of approximately \$51,000. These amounts include net credits of approximately \$835,000 for 2008 and approximately \$1,054,000 for 2007, for rebates, refunds, etc. of previously expensed items. Although there was no 2008 expense, the Agency also spent an additional \$811,818 in fiscal year 2006 for "Seams Elimination Cost Adjustment" expenses, which directly relates to the MISO market.

Late in fiscal year 2004, the Agency began a relationship with American Municipal Power of Ohio (AMP-Ohio) in order to facilitate the Agency's MISO market participation. For an approximate \$235,000 in fiscal year 2008 annual fees, the Agency is able to utilize the services of AMP-Ohio's energy control center. This arrangement has allowed the Agency to avoid creating and staffing its own control center. This relationship has broadened to include a bilateral sales agreement, an excess capacity sales agreement, an interagency services agreement, future power supply planning and resource management services, and the acceptance of the Agency's members as full AMP-Ohio members in July of 2006.

MICHIGAN SOUTH CENTRAL POWER AGENCY

MANAGEMENT'S DISCUSSION AND ANALYSIS (cont.)

June 30, 2008 and 2007

AGENCY FINANCIAL ANALYSIS (cont.)

The Agency is continuing to reap the benefits of two bond transactions which were completed in fiscal year 2005. In late October 2004, a seven percent fixed rate bond was replaced by a variable rate note. This transaction has yielded interest savings of approximately \$961,000 through fiscal year 2008. This savings is in addition to the \$127,000 in total savings due to the October 2004 defeasance of approximately \$1,060,000 in principal and interest payments on other outstanding debt.

The Agency converted its 2004 variable rate bonds to a fixed rate on August 1, 2007. The Agency issued \$9,170,000 of bonds and refunded \$9,200,000 of 2004 variable rate bonds.

No significant staffing changes occurred at the Agency during the last fiscal year.

An analysis of the Agency's financial position begins with the review of the Balance Sheet, the Statement of Revenues, Expenses and Changes in Net Assets and the Statement of Cash Flows report information. A summary of the Agency's Balance Sheet is presented in Table 1. The Statement of Revenues, Expenses and Changes in Net Assets are summarized in Table 2 and Table 3 presents a summary of the Statement of Cash Flows.

Table 1
Condensed Balance Sheet

	2008	2007	2006
Current assets	\$ 13,427,458	\$ 13,289,037	\$ 11,565,787
Restricted assets	17,762,148	17,556,019	18,814,631
Other assets	10,687,072	8,600,969	9,524,260
Utility plant	32,849,328	35,260,983	36,336,950
Total Assets	<u>74,726,006</u>	<u>74,707,008</u>	<u>76,241,628</u>
Non-current liabilities	30,632,986	39,133,715	46,795,374
Current liabilities	14,294,927	12,057,068	11,941,487
Total Liabilities	<u>44,927,913</u>	<u>51,190,783</u>	<u>58,736,861</u>
Net Assets			
Invested in capital assets, net of related debt	(5,344,508)	(10,599,731)	(16,911,477)
Restricted	17,432,281	17,199,220	18,381,657
Unrestricted	17,710,320	16,916,736	16,034,587
Total Net Assets	<u>29,798,093</u>	<u>23,516,225</u>	<u>17,504,767</u>
Total Net Assets and Liabilities	<u>\$ 74,726,006</u>	<u>\$ 74,707,008</u>	<u>\$ 76,241,628</u>

MICHIGAN SOUTH CENTRAL POWER AGENCY

MANAGEMENT'S DISCUSSION AND ANALYSIS (cont.)

June 30, 2008 and 2007

AGENCY FINANCIAL ANALYSIS (cont.)

Table 2
Condensed Statement of Revenues, Expenses and Changes in Net Assets

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Operating revenues	\$ 45,869,712	\$ 42,858,324	\$ 44,961,391
Depreciation expense	3,384,128	3,281,012	2,999,543
Other operating expenses	<u>35,215,612</u>	<u>32,251,849</u>	<u>34,276,073</u>
Total Operating Expenses	<u>38,599,740</u>	<u>35,532,861</u>	<u>37,275,616</u>
Operating income	<u>7,269,972</u>	<u>7,325,463</u>	<u>7,685,775</u>
Investment and miscellaneous income	1,511,422	1,540,548	784,118
Interest and amortization expense	(2,491,090)	(2,860,532)	(3,830,787)
Other income (expense)	<u>(8,436)</u>	<u>5,979</u>	<u>11,432</u>
Total Non-Operating Expenses	<u>(988,104)</u>	<u>(1,314,005)</u>	<u>(3,035,237)</u>
Income Before Cumulative Effect of Change in Accounting Principle	6,281,868	6,011,458	4,650,538
Cumulative effect of change in accounting principle	-	-	<u>(2,369,352)</u>
Change in Net Assets	6,281,868	6,011,458	2,281,186
NET ASSETS – Beginning of Year	<u>23,516,225</u>	<u>17,504,767</u>	<u>15,223,581</u>
NET ASSETS – END OF YEAR	<u><u>\$ 29,798,093</u></u>	<u><u>\$ 23,516,225</u></u>	<u><u>\$ 17,504,767</u></u>

MICHIGAN SOUTH CENTRAL POWER AGENCY

MANAGEMENT'S DISCUSSION AND ANALYSIS (cont.) June 30, 2008 and 2007

AGENCY FINANCIAL ANALYSIS (cont.)

Table 3
Condensed Statement of Cash Flows

	2008	2007	2006
Received from power sales	\$ 45,154,806	\$ 43,038,111	\$ 45,158,951
Paid to suppliers for purchased power and transmission	(30,390,467)	(29,717,526)	(31,426,615)
Paid to suppliers and employees for other services	(3,978,671)	(3,634,524)	(3,748,825)
Cash Flows from Operating Activities	10,785,668	9,686,061	9,983,511
Deferred rate stabilization withdraw	-	-	(3,500,000)
Cash Flows from Noncapital Financing Activities	-	-	(3,500,000)
Debt principal and interest paid	(19,391,595)	(10,324,420)	(10,162,399)
Net debt issuance costs, proceeds and defeasance Costs	9,206,695	-	-
Net acquisition, disposal, and cash contribution for capital assets	(980,909)	(2,199,066)	(2,277,647)
Cash Flows from Capital and Related Financing Activities	(11,165,809)	(12,523,486)	(12,440,046)
Cash Flows from Investing Activities	873,353	75,191	4,746,923
Net Change in Cash and Cash Equivalents	493,212	(2,762,234)	(1,209,612)
CASH AND CASH EQUIVALENTS - Beginning of Year	6,507,934	9,270,168	10,479,780
CASH AND CASH EQUIVALENTS - ENDING OF YEAR	\$ 7,001,146	\$ 6,507,934	\$ 9,270,168

BALANCE SHEET

"Current assets" and "Restricted assets" were relatively unchanged between fiscal 2008 and fiscal 2007. "Current assets" increased and "Restricted assets" increased for 2007 as overfunded bond reserve monies were moved to unrestricted assets. "Other assets" increased by \$2.1 million during fiscal year 2008, primarily due to an increase in long-term investments thereby increasing investment income. "Other assets" decreased by \$.9 million during fiscal year 2007, consisting of two offsetting items. A scheduled major turbine repair was performed during the annual Agency outage approximating \$1.9 million, which the board elected to defer the related costs and spread the charges starting in the current year and the remainder to future years, resulting in an increase in "Other assets". The offsetting item was the internal funding of capital projects which decreased "Other assets".

MICHIGAN SOUTH CENTRAL POWER AGENCY

MANAGEMENT'S DISCUSSION AND ANALYSIS (cont.) June 30, 2008 and 2007

BALANCE SHEET (cont.)

The Agency's commitment to maintaining and improving the Plant in order to provide reliable, value-based electricity to its members is reflected in the stability of the Utility Plant balance. The change in fiscal 2008's Utility Plant number is primarily due to the depreciation of \$3.4 million offset by projects capitalized during the year. For fiscal 2007, the change was the net effect of two larger transactions. In fiscal 2007, the Agency hired an outside firm to perform a major capital project in the boiler area during its annual outage of approximately \$1,070,000. Additionally, the Agency elected to buyout an existing lease on equipment during the year of approximately \$350,000. The \$1.42 million, from these internally-funded transactions, combined with other net additions which totaled approximately \$.78 million, offset a large portion of the approximately \$3.3 million in normal depreciation costs. For fiscal 2006, the largest addition was a \$1.881 million 31.5 MW of EHV transmission lines from METC.

As was the case in fiscal year 2007 and 2006, the Agency continues to reap the benefits of debt service payments that are aggressively reducing principal instead of just covering interest requirements. The reduction in Total Liabilities reflects this fact.

STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

Operating revenues and expenses for fiscal 2008 increased by 7.0 and 8.6 percent versus fiscal 2007. Higher power, fuel and transportation costs were the primary drivers of the increase from the prior year. Fiscal 2007 operating revenues and expenses decreased by minor amounts (4.7 and 4.6 percent, respectively) when compared to fiscal 2006. These decreases were a result of refunds from MISO as stated earlier, which were charged previously to the Agency during the first full year of operations in fiscal 2006. Additionally, excess power sales to AMP-Ohio provide for a more consistent level of operation at the Endicott Generating Station, which leads to more efficient operations. The similar outcome in Operating Income for fiscal year 2008 and 2007 is tied to the Agency's need to meet bond covenants.

"Investment and miscellaneous income" remained relatively unchanged between fiscal 2008 and fiscal 2007. The change between fiscal year 2007 and fiscal year 2006 was due to unrealized gains from investment performance increasing by approximately \$260,000 during fiscal year 2007 versus decreasing approximately \$487,000 during fiscal year 2006.

The "Cumulative effect of change in accounting principle" reclassifies data previously found in a Footnote to the Financial Statements ("Deferred Rate Stabilization") to a component of Net Assets. The Agency believes that this accounting change creates a more user-friendly financial statement. Further information may be found in the previously-mentioned Footnote.

MICHIGAN SOUTH CENTRAL POWER AGENCY

MANAGEMENT'S DISCUSSION AND ANALYSIS (cont.)

June 30, 2008 and 2007

STATEMENT OF CASH FLOWS

"Cash and cash equivalents" are defined as investments which mature in 90 days or less, plus immediately accessible bank accounts. The "Cash and cash equivalents" amount was relatively unchanged for the year. For the year ended June 30, 2007, the Agency had increased its short term investment position to increase investment return within its debt service accounts by approx. \$2.0 million over fiscal year 2006. Although those investments matured by November 2nd 2007, they were just out of the 90 day window to be classified as cash equivalents. Another area that affected the Statement of Cash Flows was that the Agency refinanced its 2004 variable rate bond issue and issued fixed rate bonds on August 1, 2008, to eliminate variable interest rate risk. Finally, another area that affected cash was using internal funds offset by interest income to fund the agency's capital projects during the fiscal year.

DEBT SERVICE COVERAGE

The Agency's bond documents require the Agency to maintain certain restrictive financial covenants, the most restrictive being the requirement that net revenues must equal at least 110% of the aggregate bond service for the year. The Agency fully met or exceeded all bond covenants for the years ended June 30, 2008, 2007 and 2006. Further details can be found in the Footnotes to the Financial Statements, under "Aggregate Bond Service Coverage."

CONTACTING AGENCY MANAGEMENT

This financial report is designed to provide our members, investors, and creditors with a general overview of Michigan South Central Power Agency's finances. Questions concerning any of the information provided in this report or requests for additional information should be addressed to Michigan South Central Power Agency, 720 Herring Rd., Litchfield, MI 49252.

MICHIGAN SOUTH CENTRAL POWER AGENCY

BALANCE SHEETS June 30, 2008 and 2007

ASSETS		2008	2007
CURRENT ASSETS			
Unrestricted cash and cash equivalents	\$	4,843,185	\$ 4,221,901
Restricted cash and investments		5,975,330	5,664,716
Unrestricted investments		501,833	2,946,506
Accounts receivable		4,496,148	3,692,780
Interest receivable		246,850	278,353
Inventory		2,953,234	1,772,000
Prepayments and other current assets		386,208	377,497
Total Current Assets		<u>19,402,788</u>	<u>18,953,753</u>
NON-CURRENT ASSETS			
Unrestricted investments		7,750,552	4,970,508
Restricted investments		11,786,818	11,891,303
Debt issue costs		672,161	1,051,663
Emissions credits		195,469	196,560
Deferred maintenance costs		1,466,565	1,766,565
Deferred costs recoverable in future years		602,325	615,673
Total Non-Current Assets		<u>22,473,890</u>	<u>20,492,272</u>
CAPITAL ASSETS			
Utility plant (including construction work in progress)		98,175,089	97,243,534
Accumulated depreciation		<u>(65,325,761)</u>	<u>(61,982,551)</u>
Total Net Capital Assets		<u>32,849,328</u>	<u>35,260,983</u>
TOTAL ASSETS	\$	<u>74,726,006</u>	\$ <u>74,707,008</u>

LIABILITIES AND NET ASSETS		
	<u>2008</u>	<u>2007</u>
CURRENT LIABILITIES		
Accounts payable and accrued expenses		
Accounts payable	\$ 3,771,025	\$ 2,015,389
Compensation and related amounts	262,188	259,304
Deferred rate stabilization	<u>1,437,938</u>	<u>1,349,476</u>
Total Accounts Payable and Accrued Expenses	<u>5,471,151</u>	<u>3,624,169</u>
Current liabilities payable from restricted assets		
Current portion of long-term debt	8,493,909	8,076,100
Accrued interest payable	<u>329,867</u>	<u>356,799</u>
Total Current Liabilities Payable from Restricted Assets	<u>8,823,776</u>	<u>8,432,899</u>
Total Current Liabilities	<u>14,294,927</u>	<u>12,057,068</u>
NON-CURRENT LIABILITIES		
Long-term debt, net of discounts, premiums and losses	30,372,088	38,836,277
Supplemental retirement obligation	<u>260,898</u>	<u>297,438</u>
Total Non-Current Liabilities	<u>30,632,986</u>	<u>39,133,715</u>
 Total Liabilities	 <u>44,927,913</u>	 <u>51,190,783</u>
NET ASSETS		
Invested in capital assets, net of related debt	(5,344,508)	(10,599,731)
Restricted for debt service	17,432,281	17,199,220
Unrestricted	<u>17,710,320</u>	<u>16,916,736</u>
Total Net Assets	<u>29,798,093</u>	<u>23,516,225</u>
 TOTAL LIABILITIES AND NET ASSETS	 <u>\$ 74,726,006</u>	 <u>\$ 74,707,008</u>

See accompanying notes to financial statements and independent auditors' report.

MICHIGAN SOUTH CENTRAL POWER AGENCY

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS Years Ended June 30, 2008 and 2007

	<u>2008</u>	<u>2007</u>
OPERATING REVENUES		
Sales to Members	\$ 42,409,515	\$ 39,765,703
Other Sales	<u>3,460,197</u>	<u>3,092,621</u>
Total Operating Revenues	<u>45,869,712</u>	<u>42,858,324</u>
OPERATING EXPENSES		
Operations	30,475,601	27,682,099
Maintenance	2,938,751	2,604,848
Administration and general	1,801,260	1,964,902
Depreciation	<u>3,384,128</u>	<u>3,281,012</u>
Total Operating Expenses	<u>38,599,740</u>	<u>35,532,861</u>
Operating Income	<u>7,269,972</u>	<u>7,325,463</u>
NON-OPERATING REVENUES (EXPENSES)		
Investment and miscellaneous income	1,341,185	1,280,160
Net increase (decrease) in the fair value of investments	170,237	260,388
Interest expense on long-term debt	(2,108,563)	(2,454,462)
Gain (loss) on disposal of assets	(8,436)	5,979
Amortization of debt costs, discounts, premiums and losses	<u>(382,527)</u>	<u>(406,070)</u>
Total Non-Operating Expenses	<u>(988,104)</u>	<u>(1,314,005)</u>
Income Before Change in Net Assets	6,281,868	6,011,458
Change in Net Assets	6,281,868	6,011,458
NET ASSETS - Beginning of Year	<u>23,516,225</u>	<u>17,504,767</u>
NET ASSETS - END OF YEAR	<u>\$ 29,798,093</u>	<u>\$ 23,516,225</u>

See accompanying notes to financial statements and independent auditors' report.

MICHIGAN SOUTH CENTRAL POWER AGENCY

STATEMENTS OF CASH FLOWS Years Ended June 30, 2008 and 2007

	2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES		
Received from sales to members and others	\$ 45,154,806	\$ 43,038,111
Paid to suppliers for goods and services	(30,390,467)	(29,717,526)
Paid to employees for services	(3,978,671)	(3,634,524)
Net Cash Flows from Operating Activities	<u>10,785,668</u>	<u>9,686,061</u>
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Capital expenditures for utility plant	(982,082)	(2,266,065)
Proceeds from sale of utility plant	1,173	66,999
Debt issuance costs and premiums	36,695	-
Proceeds from debt conversion	9,170,000	-
Principal payments on long-term debt	(17,256,100)	(7,793,783)
Interest payments on long-term debt	(2,135,495)	(2,530,637)
Cash Flows From Capital and Related Financing Activities	<u>(11,165,809)</u>	<u>(12,523,486)</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from sales and maturities of investments	25,186,313	10,323,237
Purchases of investments	(25,681,618)	(11,382,971)
Interest received	1,368,658	1,134,925
Cash Flows from Investing Activities	<u>873,353</u>	<u>75,191</u>
Net Change in Cash and Cash Equivalents	493,212	(2,762,234)
CASH AND CASH EQUIVALENTS – Beginning of Year	<u>6,507,934</u>	<u>9,270,168</u>
CASH AND CASH EQUIVALENTS – END OF YEAR	<u>\$ 7,001,146</u>	<u>\$ 6,507,934</u>
NONCASH INVESTING ACTIVITY		
Unrealized gains (losses) on investments	<u>\$ 174,267</u>	<u>\$ 357,307</u>
NONCASH CAPITAL AND RELATED FINANCING ACTIVITIES		
Amortization of debt costs, discounts, premiums, and losses	<u>\$ (382,527)</u>	<u>\$ (406,070)</u>
Loss on disposal of assets	<u>\$ (8,436)</u>	

	2008	2007
RECONCILIATION OF OPERATING INCOME TO NET CASH FLOWS FROM OPERATING ACTIVITIES		
Operating income	\$ 7,269,972	\$ 7,325,463
Noncash items included in operating income		
Depreciation	3,384,128	3,281,012
Deferred maintenance	300,000	(1,594,846)
Changes in assets and liabilities		
Accounts receivable	(803,368)	57,104
Inventory	(1,181,234)	(121,869)
Prepayments and other current assets	(8,711)	18,909
Emissions credits	1,091	366,760
Deferred costs	13,348	146,651
Accounts payable	1,755,636	78,706
Compensation and related amounts	(33,656)	5,488
Deferred rate stabilization	88,462	122,683
NET CASH FLOWS FROM OPERATING ACTIVITIES	\$ 10,785,668	\$ 9,686,061
RECONCILIATION OF CASH AND CASH EQUIVALENTS TO THE BALANCE SHEET		
Unrestricted cash and cash equivalents	\$ 4,843,185	\$ 4,221,901
Restricted cash and investments - current	5,975,330	5,664,716
Unrestricted investments - current	501,833	2,946,506
Restricted investments - non-current	11,786,818	11,891,303
Unrestricted investments - non-current	7,750,552	4,970,508
Total Cash and Investments	30,857,718	29,694,934
Less: Long-Term Investments	(23,856,572)	(23,187,000)
TOTAL CASH AND CASH EQUIVALENTS	\$ 7,001,146	\$ 6,507,934

See accompanying notes to financial statements and independent auditors' report.

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2008 and 2007

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND NATURE OF OPERATIONS

The Michigan South Central Power Agency (the Agency) is a body politic and corporate, of the State of Michigan organized on March 21, 1978, under the authority of Michigan Public Act 448 of 1976 (the Act), to supply electricity to member municipalities in south central Michigan. The Act provides that the Agency will establish rates and charges so as to produce revenues sufficient to cover costs (excluding depreciation and amortization expense) including debt service, but it may not operate its projects for profit, except insofar as any such profit will insure to the benefit of the public.

The Agency's member municipalities are the Cities of Coldwater, Hillsdale and Marshall and the Village's of Clinton and Union City. Each member is a municipal corporation, organized under the laws of the State of Michigan, which owns and operates a municipal electric system. The member municipalities presently supply their customers with power and energy generated from the Agency's Project I, from the municipalities' existing generating facilities and with power purchased from other utility companies. Project I consists of a 55 MW coal fired generation facility and related transmission and substation equipment. Project II consists of a series of diesel fired peaking units capable of producing 16.5 megawatts of power. Project III consists of a series of diesel fired peaking units capable of producing 14.85 megawatts of power. The participants of Project I and Project III are the Cities of Coldwater, Hillsdale and Marshall, and the Villages of Clinton and Union City. All members except the Village of Union City are participants in Project II.

Each of the member municipalities entered into (a) a Power Sales Contract with the Agency for the supply of power and energy from the Agency and (b) a Substation Agreement with the Agency for services provided by the Agency to the member municipality with respect to substation facilities; both of these agreements will remain in effect as long as Power Supply System Revenue Refunding Bonds (Revenue Refunding Bonds), 2004, 2002, and 1992 Series and Power Supply System Revenue Bonds 2003 and 2000 Series are outstanding. Each member municipality also entered into an Economic Dispatch Agreement with the Agency providing for the dispatch by the Agency of power and energy from certain existing generating facilities of the member municipalities on an economic basis. The Power Sales Contract between the Agency and the member municipalities require the Agency to provide, and the member municipalities to purchase from the Agency, all of the members' bulk power supply, as defined in the contracts. Each member is obligated to pay its share of the Agency's operating and debt service costs of Project I. The Substation Agreements require the Agency to provide, and the municipalities to purchase, services of the municipalities' substation facilities for transmission, transformation and delivery of electric power and energy from the Agency to the municipalities. Under the Economic Dispatch Agreement, the member municipalities are required to sell to the Agency power generated by their facilities, defined as dedicated capacity.

During the years ended June 30, 2008 and 2007, substantially all sales of power recognized by the Agency were made to its member municipalities.

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2008 and 2007

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND NATURE OF OPERATIONS (cont.)

BASIS OF PRESENTATION

In accordance with Governmental Accounting Standards Board (GASB) No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that use Proprietary Fund accounting*, the Agency applies all applicable GASB pronouncements as well as all Financial Accounting Standards Board (FASB) Statements and Interpretations, Accounting Principals Board (APB) Opinions, and Accounting Research Bulletins (ARB), unless those pronouncements conflict with or contradict GASB pronouncements.

The Agency's accounts are maintained in accordance with the Uniform System of Accounts of the Federal Energy Regulatory Commission, as required by the Power Sales Contracts with the member municipalities, and in conformity with accounting principles generally accepted in the United States of America. A separate set of plant accounts is maintained for each of the Agency's projects.

USE OF ESTIMATES

Preparation of financial statements in conformity with generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported period. Actual results could differ from those estimates.

CAPITAL ASSETS – UTILITY PLANT

The Agency capitalizes assets with an original cost of \$5,000 or more and a useful life of at least two years. The cost of utility plant includes direct and overhead costs. Interest incurred during construction is reflected in the capitalized value of assets, net of interest earned on the invested proceeds over the same period.

When property subject to depreciation is retired or otherwise disposed of in the normal course of business, its cost, together with the cost of removal less salvage, is charged to accumulated depreciation.

The cost of maintenance, repairs and replacements of minor items of property is charged to maintenance expense. The cost of replacements of property is charged to utility plant accounts.

Utility plant in service is depreciated using the straight-line method over the following useful lives:

	<u>Years</u>
Utility Plant in Service	
Project I (composite) – Endicott Generation Station	30
Project II (composite) – Diesel Fired Peaking Unit	30
Project III (composite) – Diesel Fired Peaking Units	30
Substation plant (composite)	30
Transmission facilities (composite)	55
Administrative and maintenance building	10 – 50
Transportation equipment	3 – 5
Furniture and fixtures	5 – 10

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2008 and 2007

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND NATURE OF OPERATIONS (cont.)

CASH EQUIVALENTS

For purposes of the statement of cash flows, cash equivalents include unrestricted checking accounts, savings accounts and institutional liquid assets, with initial maturities less than 90 days, excluding reserve accounts.

RESTRICTED AND UNRESTRICTED INVESTMENTS

The Agency follows GASB No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*. This standard requires investments to be reported at fair value with gains and losses included in the Statements of Revenues, Expenses and Changes in Net Assets. Market values may have changed significantly since year end.

INVENTORY

Inventory is stated at average carrying cost and consists of coal, limestone and fuel oil.

PREPAYMENTS AND OTHER CURRENT ASSETS

These balances represent payments in the current year that will benefit future periods and the net cash surrender value of key retired employees' life insurance.

EMISSIONS CREDITS

Emissions credits are accounted for at average cost carried at the lower of cost or market.

DEBT RELATED ITEMS

Bond issuance costs, premiums and discounts are deferred and amortized over the life of the bonds based on the effective interest method, with the exception of the 2002, 2003, and 2004 bond costs which are amortized on a straight line basis. Losses on refundings are amortized on the straight line method effective in fiscal 2003.

DEFERRED COSTS AND CREDITS

The Agency has adopted the provisions of Statement of Financial Accounting Standards (FAS) No. 71, *Accounting for the Effects of Certain Types of Regulation* (FAS No. 71). This accounting standard provides for the deferral of costs and revenues which will be recovered through future rate adjustments.

OPERATING REVENUES

The Agency distinguishes *operating* revenues and expenses from *nonoperating* items. Operating revenues and expenses generally result from providing services and producing and delivering electric service in connection with the Agency's principal ongoing operations. The principal operating revenues of the Agency are charges to members for sales and services. Operating expenses for the Agency include the cost of sales and services, administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2008 and 2007

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND NATURE OF OPERATIONS (cont.)

OPERATING REVENUES (cont.)

Agency billings are rendered and recorded monthly based on month end metered usage. No accrual for unbilled service is necessary. As all payments are received from Agency members for current service, no allowance for doubtful accounts is considered necessary.

INTEREST INCOME CREDIT

If approved by the Agency's rate-making body, the Agency may grant to its members a credit for interest income earned from the pool of temporary investments held by the Agency. There were no interest income credits granted to the Agency's members for the years ended June 30, 2008 and 2007.

TAXES

The Agency is exempt from State and Federal income taxes.

COMPENSATED ABSENCES AND RELATED AMOUNTS

Under terms of employment, non-union employees are granted twelve sick and personal days per year on January 1st. This time cannot be carried over from year to year and is not paid out at year end. Vacation time does accrue for all employees, and up to one week (Union) on one-half of the annual accrual (non-union) may be carried over at year end. Sick leave and vacation benefits earned but not yet taken have been recorded in the financial statements. Union employees are granted three personal days per year which cannot be carried over from year to year.

The current portion of the supplemental retirement obligation, detailed in Note 9, is included with compensation and related amounts on the balance sheet.

COMPARATIVE DATA

Certain amounts presented in the prior year data have been reclassified in order to be consistent with the current year's presentation.

NOTE 2 – CASH AND INVESTMENTS

The Agency's Trust Indenture for the Power Supply System Revenue Refunding Bonds (Note 5) authorizes the Agency to deposit funds only in banks insured by the Federal Deposit Insurance Corporation. The Agency may also make investments in U.S. Government and Federal Agency obligations, investment grade bonds, commercial paper rated at the highest classification established by at least two standard rating services, money market mutual funds, repurchase agreements, and pooled investment funds. The Agency's internal policy is to not invest funds in repurchase agreements.

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS

June 30, 2008 and 2007

NOTE 2 – CASH AND INVESTMENTS (cont.)

Investments are stated at fair value, which is the amount at which an investment could be exchanged in a current transaction between willing parties. Fair values are based on quoted market prices. No investments are reported at amortized cost. Adjustments necessary to record investments at fair value are recorded in the operating statement as increases or decreases in investment income.

Deposits in banks are insured by the FDIC in the amount of \$100,000 for all interest bearing accounts and \$100,000 for all noninterest bearing accounts. The difference between the bank balance and carrying amount is due to outstanding checks, deposits in transit, and/or market value adjustments.

The CLASS investment (Cooperative Liquid Assets Securities System) is an investment pool established by an intergovernmental agreement dated October 1, 1991. CLASS is available for investment by Michigan governmental entities except school districts. CLASS operates consistent with the provisions of a 2a-7 like pool, and invests only in investments legally permissible under Michigan law, with a weighted average maturity not exceeding 120 days. The value of pool shares is the same as the fair value position in the pool.

CUSTODIAL CREDIT RISK

Deposit

Custodial credit risk is the risk that in the event of a financial institution failure, the Agency's deposits may not be returned to the Agency.

As of June 30, 2008 and 2007, \$0 and \$90,888 of the Agency's total bank balances of \$313,595 and \$331,178, respectively, were exposed to custodial credit risk as it was uninsured and uncollateralized.

This Agency's investment policy specifies that the Agency shall only invest in depositories deemed appropriate by the Bond Resolution securing the Agency's debt.

Investment

For an investment, custodial credit risk is the risk that, in the event of the failure of the counterparty, the Agency will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party.

As of June 30, 2008 and 2007, no investments were exposed to custodial credit risk.

This Agency's investment policy specifies that the Agency shall only invest in securities deemed appropriate by the Bond Resolution securing the Agency's debt.

CREDIT RISK

Credit risk is the risk an issuer or other counterparty to an investment will not fulfill its obligations.

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2008 and 2007

NOTE 2 – CASH AND INVESTMENTS (cont.)

CREDIT RISK (cont.)

As of June 30, 2008 and 2007, the Agency's investments were rated as follows:

<u>Investment Type</u>	<u>Standard & Poor's</u>
US Agency securities	AAA

The Agency also held investments in the following investments which are not rated:

- External pool – Comerica
- Mutual funds – U.S. Bank
- Mutual funds – Fidelity
- MI Class
- MISO security deposit (held in mutual fund)

This Agency's investment policy specifies the Agency shall only invest in securities deemed appropriate by the Bond Resolution securing the Agency's debt.

CONCENTRATION OF CREDIT RISK

Concentration of credit risk is the risk of loss attributed to the magnitude of a government's investment in a single issuer. At June 30, 2008 and 2007, the investment portfolio was concentrated as follows:

<u>Investment Type</u>	<u>Issuer</u>	<u>Percentage of Portfolio</u>	
		<u>2008</u>	<u>2007</u>
US Government Agency Securities	Federal Farm Credit	17%	21%
	Federal Home Loan Bank	18%	25%
	Federal Home Loan Mortgage	21%	17%
	Federal National Mortgage Association	15%	18%

This Agency's investment policy specifies that no single issuer shall comprise greater than 25 percent of the overall portfolio, when measured at the last investment purchase date. Securities which are explicitly backed by the full faith and credit of the United States Government shall not be aggregated when measuring portfolio concentration.

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2008 and 2007

NOTE 2 – CASH AND INVESTMENTS (cont.)

INTEREST RATE RISK

Interest rate risk is the risk changes in interest rates will adversely affect the fair value of an investment. As of June 30, 2008, the Agency's investments were as follows:

Investment Type	Fair Value	Maturity	
		Less than 1 Year	1 – 5 Years
US Government			
Agency Securities	\$ 21,029,555	\$ 5,524,431	\$ 15,505,124
Other external pools	256,242	256,242	-
Mutual funds	8,291,961	8,291,961	-
Totals	<u>\$ 29,577,758</u>	<u>\$ 14,072,634</u>	<u>\$ 15,505,124</u>

As of June 30, 2007, the Agency's investments were as follows:

Investment Type	Fair Value	Maturity	
		Less than 1 Year	1 – 5 Years
US Government			
Agency Securities	\$ 23,917,651	\$ 12,246,195	\$ 11,671,456
Other external pools	1,377	1,377	-
Mutual funds	4,890,536	4,890,536	-
Totals	<u>\$ 28,809,564</u>	<u>\$ 17,138,108</u>	<u>\$ 11,671,456</u>

This Agency's investment policy specifies operating funds shall be maintained in liquid investments such as money market funds, municipal investment pools, and savings accounts. Investments greater than five years are not allowed.

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2008 and 2007

NOTE 3 – RESTRICTED AND UNRESTRICTED INVESTMENTS

The Power Supply System Revenue Bond Resolution requires that the payments by the member municipalities for project power be deposited into special funds and that they be used only for operating costs, debt service and other stipulated purposes. The fund's purposes and balances are summarized below.

<u>Fund</u>	<u>Purpose</u>
Operations and Maintenance	To accumulate sufficient funds by the end of each month to pay the subsequent month's expenses.
Bond Service Fund	To accumulate funds to pay the current portion of the bond principal and interest.
Bond Reserve Fund	To reserve funds equal to the maximum annual principal and interest requirements for the outstanding bonds.
Reserve and Contingency Fund	To reserve funds for major renewals and replacements, extraordinary operations and maintenance costs, and any contingencies.

The following is a summary of investments as of June 30, 2008 and 2007:

	<u>2008</u>	<u>2007</u>
Current Investments		
Restricted		
Bond service fund	\$ 5,836,170	\$ 5,664,716
MISO security deposit	139,160	-
Unrestricted	501,833	2,946,506
Total Current Investments	<u>6,477,163</u>	<u>8,611,222</u>
Non-Current Investments		
Restricted		
Bond reserve fund	10,696,238	10,800,723
Reserve and contingency fund	1,090,580	1,090,580
Unrestricted	7,750,552	4,970,508
Total Non-Current Investments	<u>19,537,370</u>	<u>16,861,811</u>
Total Investments	26,014,533	25,473,033
MISO security deposit – unrestricted	460,840	-
Cash and cash equivalents – unrestricted	<u>4,382,345</u>	<u>4,221,901</u>
Total Cash and Investments	<u>\$ 30,857,718</u>	<u>\$ 29,694,934</u>

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2008 and 2007

NOTE 4 – CHANGES IN CAPITAL ASSETS

A summary of changes in capital assets for 2008 and 2007 follows:

2008

	Balance 7/01/07	Additions/ Reclassi- fications	Deletions/ Reclassi- fications	Balance 6/30/08
Capital assets, not being depreciated				
Land	\$ 1,403,519	\$ -	\$ -	\$ 1,403,519
Construction work in progress	77,379	897,514	(751,551)	223,342
Total Capital Assets, Not Being Depreciated	1,480,898	897,514	(751,551)	1,626,861
Capital assets being depreciated				
Project I (composite) - Generation Station	82,800,044	643,914	(23,410)	83,420,548
Project II (composite) - Diesel Fired Peaking Unit	5,920,980	-	-	5,920,980
Project III	2,233,821	72,593	-	2,306,414
General Plant	4,807,791	119,612	(27,117)	4,900,286
Total Capital Assets Being Depreciated	95,762,636	836,119	(50,527)	96,548,228
Total Capital Assets	97,243,534	1,733,633	(802,078)	98,175,089
Less: Accumulated Depreciation				
Project I (composite) - Generation Station	56,662,515	2,983,667	(13,801)	59,632,381
Project II (composite) - Diesel Fired Peaking Unit	1,069,038	197,366	-	1,266,404
Project III	251,238	74,809	-	326,047
General Plant	3,999,760	128,286	(27,117)	4,100,929
Total Accumulated Depreciation	61,982,551	3,384,128	(40,918)	65,325,761
Net Capital Assets	\$ 35,260,983			\$ 32,849,328

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2008 and 2007

NOTE 4 – CHANGES IN CAPITAL ASSETS (cont.)

2007

	Balance 7/01/06	Additions/ Reclassi- fications	Deletions/ Reclassi- fications	Balance 6/30/07
Capital assets, not being depreciated				
Land	\$ 1,403,519	\$ -	\$ -	\$ 1,403,519
Construction work in progress	156,279	1,421,001	(1,499,901)	77,379
Total Capital Assets, Not Being Depreciated	1,559,798	1,421,001	(1,499,901)	1,480,898
Capital assets being depreciated				
Project I (composite) - Generation Station	80,948,783	1,913,124	(61,863)	82,800,044
Project II (composite) - Diesel Fired Peaking Unit	5,920,980	-	-	5,920,980
Project III	2,200,000	102,446	(68,625)	2,233,821
General Plant	4,703,447	329,395	(225,051)	4,807,791
Total Capital Assets Being Depreciated	93,773,210	2,344,965	(355,539)	95,762,636
Total Capital Assets	95,333,008	3,765,966	(1,855,440)	97,243,534
Less: Accumulated Depreciation				
Project I (composite) - Generation Station	53,821,433	2,902,946	(61,864)	56,662,515
Project II (composite) - Diesel Fired Peaking Unit	871,672	197,366	-	1,069,038
Project III	183,334	75,529	(7,625)	251,238
General Plant	4,119,619	105,171	(225,030)	3,999,760
Total Accumulated Depreciation	58,996,058	3,281,012	(294,519)	61,982,551
Net Capital Assets	\$ 36,336,950			\$ 35,260,983

NOTE 5 – LONG-TERM DEBT

The Agency has issued the following revenue bonds:

Date	Purpose	Final Maturity	Interest Rate	Original Issue
Dec. 28, 2000	Project II	May 1, 2012	6.00%	\$ 6,475,000

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS

June 30, 2008 and 2007

NOTE 5 – LONG-TERM DEBT (cont.)

The annual bond service requirements of the 2000 bonds to maturity are as follows:

<u>Fiscal Year</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2009	\$ -	\$ 360,000	\$ 360,000
2010	990,000	360,000	1,350,000
2011	1,095,000	300,600	1,395,600
2012	3,915,000	234,900	4,149,900
Totals	<u>\$ 6,000,000</u>	<u>\$ 1,255,500</u>	<u>\$ 7,255,500</u>

<u>Date</u>	<u>Purpose</u>	<u>Final Maturity</u>	<u>Interest Rate</u>	<u>Original Issue</u>
Nov. 21, 2002	Refunding of 1991 and 1986 revenue refunding bonds	Nov. 1, 2010	5.00%	\$ 31,190,000

The annual bond service requirements of the 2002 bonds to maturity are as follows:

<u>Fiscal Year</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2009	\$ 7,895,000	\$ 985,375	\$ 8,880,375
2010	8,290,000	580,750	8,870,750
2011	7,470,000	186,750	7,656,750
Totals	<u>\$ 23,655,000</u>	<u>\$ 1,752,875</u>	<u>\$ 25,407,875</u>

<u>Date</u>	<u>Purpose</u>	<u>Final Maturity</u>	<u>Interest Rate</u>	<u>Original Issue</u>
Sept. 3, 2003	Project III	Nov. 1, 2010	3.95%	\$ 2,220,000

The annual bond service requirements of the 2003 bonds to maturity are as follows:

<u>Fiscal Year</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2009	\$ 333,909	\$ 30,701	\$ 364,610
2010	347,229	17,382	364,611
2011	178,776	3,531	182,307
Totals	<u>\$ 859,914</u>	<u>\$ 51,614</u>	<u>\$ 911,528</u>

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2008 and 2007

NOTE 5 – LONG-TERM DEBT (cont.)

<u>Date</u>	<u>Purpose</u>	<u>Final Maturity</u>	<u>Interest Rate</u>	<u>Original Issue</u>
Oct. 21, 2004	Refunding of 1994 revenue Refunding bond	Nov. 1, 2011	4.5%	\$ 9,200,000

In August 2007, the 2004 bonds were converted from a variable interest to a fixed rate ranging from 4.25 – 4.5%. As a part of this transaction the Agency also made an additional \$30,000 principal payment. The annual bond service requirements of the converted 2004 bonds to maturity are as follows:

<u>Fiscal Year</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2009	\$ 265,000	\$ 396,857	\$ 661,857
2010	175,000	387,397	562,397
2011	225,000	378,647	603,647
2012	8,305,000	186,863	8,491,863
Totals	<u>\$ 8,970,000</u>	<u>\$ 1,349,764</u>	<u>\$ 10,319,764</u>

Long-term debt activity for the year ended June 30, 2008 and 2007 is as follows:

	<u>07/01/07 Balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>6/30/08 Balance</u>	<u>Due Within One Year</u>
Revenue bonds	\$ 47,571,014	\$ 9,170,000	\$ 17,256,100	\$ 39,484,914	<u>\$ 8,493,909</u>
Discounts/Premiums	833,294	152,548	269,741	716,101	
Loss on refunding	<u>(1,491,931)</u>	<u>(1,649,416)</u>	<u>(1,806,329)</u>	<u>(1,335,018)</u>	
Net Bonds	<u>\$ 46,912,377</u>			<u>\$ 38,865,997</u>	
Supplemental Retirement Obligation	\$ 326,477	\$ -	\$ 36,540	\$ 38,865,997	<u>\$ 29,039</u>
Total Non-Current Liabilities	<u>\$ 47,238,854</u>			<u>\$ 39,155,934</u>	

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2008 and 2007

NOTE 5 – LONG-TERM DEBT (cont.)

	07/01/06 Balance	Additions	Reductions	6/30/07 Balance	Due Within One Year
Revenue bonds	\$ 55,364,797	-	\$ 7,793,783	\$ 47,571,014	\$ 8,076,100
Discounts/Premiums	1,067,448	-	234,154	833,294	
Loss on refunding	(1,843,088)	-	(351,157)	(1,491,931)	
Net Bonds	<u>\$ 54,589,157</u>			<u>\$ 46,912,377</u>	
Supplemental Retirement Obligation	\$ 325,816	\$ 29,700	\$ 29,039	\$ 326,477	\$ 29,039
Total Non-Current Liabilities	<u>\$ 54,914,973</u>			<u>\$ 47,238,854</u>	

PRIOR YEAR DEFEASANCE OF DEBT

In October of 2004, the utility defeased \$475,000 of the 2000 bonds by placing the proceeds of the 2004 bonds and other sinking fund monies in an irrevocable trust to provide for all future debt service payments on the defeased bonds. Accordingly, the trust account assets and the liability for the defeased bonds are not included in the Agency's financial statements. The bonds will be paid in full on May 1, 2011. At June 30, 2008, \$475,000 of bonds outstanding are considered defeased.

2004 BONDS – CONVERSION TO FIXED RATE

In August of 2007, the agency converted its 2004 variable rate bonds to a fixed rate. The agency issued \$9,170,000 in bonds with an average interest rate of 4.35% to refund \$9,200,000 of outstanding 2004 bonds with a variable interest rate.

The cash flow requirements on the old bonds prior to the conversion were estimated at \$10,680,839 from fiscal years 2007 through 2012. The cash flow requirements on the new bonds are \$10,799,656 from fiscal years 2007 through 2012. As the original 2004 refunded bonds were variable interest rate debt the exact debt service is not known at this time. This estimate was provided by the agency's financial adviser using an interest rate of 4.025% over the life of the bonds. The advance refunding resulted in an estimated net savings of \$586,344 if the original debt had been fixed rate and an economic loss of \$114,848 based on the assumed interest rate of 4.025% on the variable rate debt. The agency completed the transaction based on market conditions indicating that the variable rate would become higher than 4.025%.

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2008 and 2007

NOTE 6 – NET DEFERRED COSTS RECOVERABLE IN FUTURE YEARS

Deferred costs recoverable in future years consist of costs incurred by the Agency which were not billed to the member municipalities during the period in which they were incurred.

These amounts were initially composed of depreciation and amortization expense (noncash expenditures which under the Power Sales Contracts cannot be billed to the member municipalities) in excess of the principal repayments on related debt. During fiscal 2006, these accumulated deferred costs were completely recovered.

Certain other costs incurred during fiscal 2007 and 2008 were deferred until the appropriate allocation between members can be determined.

GAAP requires that these items be removed from the statements of net revenues and expenses and accumulated equity, and recorded as an asset or liability in the year in which they were incurred. These items are then recognized in future years when the items are included as allowable costs for rate-making purposes.

The components of the deferred costs recoverable in future years as of June 30, 2008 and 2007 are as follows:

	<u>2008</u>	<u>2007</u>
Deferred costs recoverable in future years		
Cost to be billed once allocation is determined	<u>\$ 602,325</u>	<u>\$ 615,673</u>

The change in the components of deferred costs recoverable in future years for the years ended June 30, 2008 and 2007, are as follows:

	<u>2008</u>	<u>2007</u>
NOX Allowance – mark-to-market	\$ (55,227)	\$ 362,620
Baseload Feasibility study	41,879	73,145
Metering project	-	(82,416)
MISO RSG	-	(500,000)
Net Increase (Decrease) in Deferred Costs	<u>(13,348)</u>	<u>(146,651)</u>
Balance at Beginning of Year	<u>615,673</u>	<u>762,324</u>
Balance at End of Year	<u>\$ 602,325</u>	<u>\$ 615,673</u>

Additionally, in 2001, the Agency's Board approved the deferral of approximately \$3,200,000 in maintenance costs incurred for the overhaul of the turbine generator. In 2008, approximately \$1,600,000 related to the turbine overhaul project was deferred. Such costs will be recognized as a component of maintenance expense. For fiscal 2008 and 2007 \$300,000 per year was recognized.

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS

June 30, 2008 and 2007

NOTE 7 – DEFERRED RATE STABILIZATION

Effective in September 1994, management of the Agency implemented a plan to provide its members with refunds utilizing assets of a rate stabilization equity fund then held by the Agency.

Effective in August 1996, management of the Agency implemented a new plan to provide rate relief in future periods to the Agency's members utilizing advance contributions of the members.

Deposits, net of withdrawals, previously included in equity were reclassified in 2003.

The equity fund, which then totaled approximately \$3,000,000 consisted of member contributions aggregating approximately \$1,200,000 and interest thereon totaling approximately \$1,800,000, and was originally established in 1986 to provide rate relief in future periods to the Agency's members. The Agency anticipates that the remaining undistributed member contributions and undistributed interest earned on the equity fund will be distributed to its members in an indeterminable period in the future out of currently available unrestricted accumulated equity.

As of June 30, 2008 and 2007, the Agency had received cumulative contributions totaling \$7,281,235 and \$7,250,504, respectively, and provided cumulative distributions to its members totaling \$8,871,533. Cumulative interest accrued on these funds to \$3,025,675 at June 30, 2008.

The Agency anticipates the member contributions will be distributed to its members in an indeterminable period in the future out of currently available unrestricted funds. Accordingly, at June 30, 2008 and 2007, the Agency has established a liability of \$1,437,938 and \$1,349,476, respectively, for Deferred Rate Stabilization.

NOTE 8 – NET ASSETS

GASB No. 34 requires the classification of net assets into three components – invested in capital assets, net of related debt; restricted; and unrestricted. These classifications are defined as follows:

Invested in capital assets, net of related debt – This component of net assets consists of capital assets, including restricted capital assets, net of accumulated depreciation and reduced by the outstanding balances of any bonds, mortgages, notes, or other borrowings that are attributable to the acquisition, construction, or improvement of those assets. If there are significant unspent related debt proceeds at year-end, the portion of the debt attributable to the unspent proceeds are not included in the calculation of invested in capital assets, net of related debt. Rather, that portion of the debt is included in the same net assets component as the unspent proceeds.

Restricted – This component of net assets consists of constraints placed on net asset use through external constraints imposed by creditors (such as through debt covenants), grantors, contributors, or laws or regulations of other governments or constraints imposed by law through constitutional provisions or enabling legislation.

Unrestricted net assets – The component of net asset consist of net assets that do not meet the definition of "restricted" or "invested in capital assets, net of related debt."

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2008 and 2007

NOTE 8 – NET ASSETS (cont.)

When both restricted and unrestricted resources are available for use, it is the Agency's' policy to use restricted resources first, then unrestricted resources as they are needed.

The following calculation supports the net assets invested in capital assets, net of related debt:

	2008	2007
Capital Assets		
Utility plant in service and work in progress	\$ 98,175,089	\$ 97,243,534
Allowance for depreciation	(65,325,761)	(61,982,551)
Related Debt		
Revenue bonds payable, less current portion (includes discounts, premiums and losses)	(30,372,088)	(38,836,277)
Current portion of revenue bonds	(8,493,909)	(8,076,100)
Deferred bond issue costs – net	672,161	1,051,663
Invested in Capital Assets, Net of Related Debt	\$ (5,344,508)	\$ (10,599,731)
Restricted Net Assets		
Restricted assets		
Bond service fund	\$ 5,836,170	\$ 5,664,716
MISO security deposit	139,160	-
Bond reserve fund – noncurrent	10,696,238	10,800,723
Reserve and contingency fund – noncurrent	1,090,580	1,090,580
Current liabilities payable from restricted assets		
Accrued interest payable	(329,867)	(356,799)
Restricted Net Assets	\$ 17,432,281	\$ 17,199,220

NOTE 9 – EMPLOYEE RETIREMENT PLAN

MUNICIPAL EMPLOYEES RETIREMENT SYSTEM OF MICHIGAN (MERS)

The Agency contributes to the Municipal Employees Retirement System of Michigan (MERS), an agent defined benefit multiple-employer public employee retirement system that acts as a common investment and administrative agent for municipalities. The Agency's defined benefit pension plan provides retirement and disability benefits to covered employees and beneficiaries. The present benefit provisions of MERS are governed by Act No. 220 of the Public Acts of 1996, as amended and the MERS Plan Document as revised. The MERS issues a publicly available financial report that includes financial statements and required supplementary information. That report may be obtained by writing to Municipal Employees Retirement System of Michigan, 447 N. Canal Road, Lansing, Michigan 48917.

The Agency funds the entire cost of each employee's participation in MERS. Contribution requirements of employees and the Agency are established and may be amended by the MERS Board of Trustees.

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS

June 30, 2008 and 2007

NOTE 9 – EMPLOYEE RETIREMENT PLAN (cont.)

For 2008, 2007, and 2006, the Agency's annual pension cost of \$283,152, \$296,352, and \$284,664, respectively, for the MERS was equal to the Agency's required and actual contributions.

The 2008 required contribution was determined as part of the December 31, 2007 actuarial valuation using the entry age normal cost method. This method seeks to provide a level pattern of cost as a percentage of salary throughout an employee's working lifetime. The actuarial assumptions included: (a) 8.0% investment rate of return in 2008, 2007, and 2006; (b) projected salary increases of 4.5% in 2008, 2007, and 2006; and (c) additional projected salary increases ranging from 0% to 8.40% in 2008, 2007, and 2006 depending on age, attributable to seniority and merit. A level percentage of payroll amortization is used, with an amortization period not to exceed 30 years.

Schedule of Funding Progress (Unaudited – Required Information)

Valuation Date	Actuarial Asset Values	Actuarial Accrued Liability (AAL)	Unfunded AAL (UAAL)	Funded Ratio	Covered Payroll	UAAL as a Percentage of Covered Payroll
December 31, 2003	\$ 4,606,439	\$ 6,276,942	\$ 1,670,503	73.4%	\$ 2,562,793	65.2%
December 31, 2004	5,081,085	6,976,587	1,895,502	72.8	2,621,348	72.3
December 31, 2005	5,562,479	7,527,441	1,964,962	73.9	2,634,274	74.6
December 31, 2006	6,118,262	8,509,040	2,390,778	71.9	2,547,127	93.9
December 31, 2007	6,684,605	8,571,533	1,886,928	78.0	2,673,111	70.6

SUPPLEMENTAL RETIREMENT PLAN

In fiscal 1999, the Agency entered into a supplemental retirement plan with a key employee to provide defined cash benefits for fifteen years after retirement, or specified benefits to a designated beneficiary in the event of death. This plan was approved by the Board of Commissioners that also have the authority to negotiate any changes in benefits. This plan is funded on a pay as you go basis by the Agency and is ultimately financed by a key employee life insurance policy payable to the Agency. The key employee retired on June 30, 2006 and began collecting benefits on July 1, 2007.

Fiscal Year End	Annual Pension Cost	Annual Contributions	Net Pension Obligation	Contributions as a Percentage of Annual Pension Cost
December 31, 2006	\$ 29,700	\$ -	\$ 325,816	0.0%
December 31, 2007	29,700	29,039	326,477	97.8
December 31, 2008	(7,500)	29,039	289,937	-387.2

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2008 and 2007

NOTE 9 – EMPLOYEE RETIREMENT PLAN (cont.)

The net pension obligation is calculated at year end based on the present value of future cash flows. The assumptions include the known fixed future payments and 4% investment return. There are no separately issued statements or reports on this plan.

NOTE 10 – LONG-TERM SUPPLY AGREEMENTS

On December 12, 2001, the Agency entered into a fixed-price contract for the continuous supply of 30 MWH of power with CMS Energy. This contract was sold to Constellation Power Services on March 27, 2003. This contract expires on December 31, 2008. The exact rates and terms of the agreement are subject to a confidentiality agreement.

In order to replace the Constellation contract, the Agency and its Members have entered into multiple development agreements with AMP-Ohio to secure long-term power supply for the future. There are currently three projects under various stages of development, including two new base load coal generation facilities and a hydro generation project. The first coal facility is currently under construction and is expected to be on line in 2012. The second coal facility is presently in the permitting stage and is projected to be on line in 2013. The hydro generation project, which currently involves the development of three hydro generation facilities on existing lock and dam facilities located on the Ohio River, is expected to be in full operation by 2012. As these projects develop, it is expected that the Agency and its Members will enter into long-term capacity and power purchase agreements with AMP-Ohio for a total of 56 MW of the base load coal projects and 13.4 MW of the hydro project.

Because these projects will not be in commercial operation until 2012, the Agency has entered into multiple bridge contracts to secure power supply for the interim. Currently, the Agency has secured fixed-priced contracts for 25 MW, 15 MW starting in January, 2009 and ending in December, 2012, and 10 MW for the period 2009-2010. It is expected that an additional 5 to 10 MW will be secured prior to the end of calendar 2008.

NOTE 11 – MARKET PARTICIPATION

The Agency began participating in the Midwest Independent System Operator (MISO) energy market on April 1, 2005. MISO invoices the Agency for net generation sales or power purchases. These invoices are subject to future true-ups based on improved data. True-ups typically occur at various periods after the actual date of service. At year end the Agency is unable to estimate the amount of future adjustments relating to periods prior to year end.

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS

June 30, 2008 and 2007

NOTE 12 – RISK MANAGEMENT

The Agency is exposed to various risks of loss related to torts, theft of, damage to, or destruction of assets, errors and omissions, workers compensation, and health care of its employees. These risks are covered through the purchase of commercial insurance with minimal deductibles. Settled claims have not exceeded the commercial liability in any of the past three years. There were no significant reductions in coverage compared to the prior year.

NOTE 13 – COMMITMENTS

The Agency has entered into contracts related to work to be commenced and completed subsequent to year end. Any service provided as of June 30, 2008 has been accrued in these financial statements.

NOTE 14 – AGGREGATE BOND SERVICE COVERAGE

June 30, 2008

NET REVENUES

Operating Revenues		\$ 45,869,712
Less: Operating Expenses		
Operations	\$ 30,475,601	
Maintenance	2,938,751	
Administration and General (a)	<u>1,761,260</u>	
Total		(35,175,612)
Plus:		
Interest and Miscellaneous Income (b)		<u>1,337,156</u>
TOTAL NET REVENUES, AS DEFINED		<u>\$ 12,031,256</u>
AGGREGATE BOND SERVICE, AS DEFINED (1)		<u>\$ 10,480,111</u>
COVERAGE OF AGGREGATE BOND SERVICE BY NET REVENUES		<u>1.15</u>

(a) Excludes payment in lieu of taxes.

(b) Excludes unrealized gains and losses on investments.

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2008 and 2007

NOTE 14 – AGGREGATE BOND SERVICE COVERAGE (cont.)

June 30, 2007

NET REVENUES

Operating Revenues		\$ 42,858,324
Less: Operating Expenses		
Operations	\$ 27,682,099	
Maintenance	2,604,848	
Administration and General	1,924,902	
Total		(32,211,849)
Plus:		
Interest and Miscellaneous Income		1,183,241
TOTAL NET REVENUES, AS DEFINED		\$ 11,829,716
AGGREGATE BOND SERVICE, AS DEFINED (1)		\$ 10,430,279
COVERAGE OF AGGREGATE BOND SERVICE BY NET REVENUES		1.13

(1) AGGREGATE BOND SERVICE, AS DEFINED

<u>Bond Service:</u>	<u>Total for Fiscal Year Ended</u>	
	<u>June 30, 2008</u>	<u>June 30, 2007</u>
1992 Series	\$ -	\$ 2,642,205
2000 Series	360,000	360,000
2002 Series	9,083,333	6,582,833
2003 Series	364,611	364,611
2004 Series	672,167	480,630
 Aggregate Bond Service	 <u>\$ 10,480,111</u>	 <u>\$ 10,430,279</u>

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2008 and 2007

NOTE 14 – AGGREGATE BOND SERVICE COVERAGE (cont.)

1. Section 6.13 of the Power Supply System Revenue Bond Resolution (the Resolution) dated August 23, 1979, as amended, for each Series of Construction Bonds requires – The Agency will, at all times while any of the bonds are Outstanding, establish, fix, prescribe and collect rates and charges for the sale or use of electric power and energy or related services produced, transmitted, distributed or furnished by the System which, together with other income, are reasonably expected to yield (a) for the forthcoming twelve-month period, Net Revenues equal to at least 1.10 times the Aggregate Bond Service for that period and, (b) at all times, Revenues at least equal to the amounts of all deposits required by the terms of the Resolution to be made into the funds and accounts held under the Resolution and not otherwise provided for. Promptly upon any material change in the circumstances which were contemplated at the time the rates and charges were most recently reviewed, but not less frequently than once in each Fiscal Year, the Agency shall review the rates and charges for electric power and energy and related services and shall promptly revise the rates and charges as necessary to comply with the foregoing requirement so that the rates and charges shall produce moneys sufficient to enable the Agency to comply with all its covenants under the Resolution.

To comply with the requirements of the above Section of the Resolution, the Michigan South Central Power Agency (the Agency) has prepared the Aggregate Bond Service Coverage Calculation for the twelve months ended June 30, 2008.

2. Definitions of the following terms included in the calculation discussed in Note 1 are as indicated in Article I Section 1.01 Definitions of the Resolution:

Net Revenues
Revenues
Operations and Maintenance Costs
Aggregate Bond Service
Bond Service

All references to Generally Accepted Accounting Principles in the above definitions are generally those currently in existence, except for those that are inconsistent with the Resolution, in which case the terms of the Resolution control.

NOTE 15 – SIGNIFICANT CUSTOMERS

The Agency has three members who are considered significant customers. These members accounted for 85% and 84% of operating revenues for the year ended June 30, 2008 and 2007, respectively.



August 29, 2008

Board of Commissioners
Michigan South Central Power Agency
720 Herring Road
Litchfield, Michigan 49252

Dear Commissioners:

We are presenting for your consideration our comments and recommendations that are intended to improve the system of internal control and promote other operating efficiencies. These matters came to our attention during our audit of the financial statements of Michigan South Central Power Agency (the Agency) for the year ended June 30, 2008 which we reported upon on August 29, 2008.

This letter, by its nature, focuses on improvements and does not comment on the many strong areas of the Agency's systems and procedures. The comments and suggestions in this letter are not intended to reflect in any way on the integrity or ability of the personnel of the Agency. These comments are made solely in the interest of establishing sound internal control practices and improving the Agency's operations.

This letter is intended solely for the information and use of the Board of Commissioners, management, and others in the organization and is not intended to be, and should not be, used by anyone other than these specified parties.

INTERNAL CONTROL

In planning and performing our audit of the financial statements of the Michigan South Central Power Agency as of and for the year ended June 30, 2008, in accordance with auditing standards generally accepted in the United States of America, we considered its internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion(s) on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of its internal control. Accordingly, we do not express an opinion on the effectiveness of its internal control.

Our consideration of the Michigan South Central Power Agency's internal control was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control that we consider to be material weaknesses.

INTERNAL CONTROL (cont.)

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control. We believe that the following deficiencies constitute material weaknesses.

- Segregation of duties
- Financial reporting

SEGREGATION OF DUTIES

Our review of internal control disclosed a reportable condition in that segregation of duties is not feasible due to the limited number of staff in the office. Currently, on some occasions the same individuals perform tasks, which under ideal situations should be segregated from each other.

For example, the same employee prepares invoices, records billing and cash receipts, and reconciles the accounts receivable account.

This situation necessitates an increased amount of management involvement in the day-to-day operation of the system. This is not unusual in entities of your size, but management should continue to be aware of this condition and realize that the concentration of duties and responsibilities in a limited number of individuals is not desirable from a control point of view.

We do note that management has instituted several checks and balances between the three office personnel to mitigate the risks associated with a limited number of staff.

Throughout the country, there is now an increased emphasis on safeguarding assets and proper financial reporting. Many organizations are evaluating their controls over financial assets and accounting functions. The role of the governing body is also evolving; with more focus on the special duty officials have to the public to ensure that your resources are properly managed. This includes periodically assessing your risk areas and determining the appropriate level of internal controls and procedures. Costs of staffing and segregation of duties need to be weighed with perceived benefits of increased accountability and safeguarding of assets.

INTERNAL CONTROL (cont.)

FINANCIAL REPORTING

In theory, a properly designed system of internal controls consists of enough people, with sufficient training, to process and record monthly transactions, as well as prepare a complete set of annual financial statements. However, while most entity's staff do a good job of processing and recording monthly transactions, the reality is that very few have the background, training or time needed to prepare annual financial statements.

The definition of a material weakness in internal control includes consideration of the year end financial reporting process including the preparation of financial statements. In order for your municipality to avoid this type of material weakness, the system of internal controls would need to be able to prepare a complete set of year end financial statements in such a condition that the auditor is not able to identify any material changes as a result of the audit. A complete set of financial statements include the balance sheets, changes in net assets and cash flows and footnote disclosures.

This high level of internal control over financial reporting can be a difficult task for governments. As opposed to large private companies, most governments operate with only enough staff to process monthly transactions and reports, and often rely on their auditors to prepare the year end entries and financial reporting. As this is the case with the Agency, we are now required to inform you that these are material weaknesses in your internal controls.

CURRENT YEAR COMMENTS

SUPPLEMENTAL RETIREMENT PLAN

During fiscal 2008 we worked with management to review the accounting and reporting for the supplemental retirement plan in light of new accounting standards applicable to other post employment benefits. As a result it was determined that this plan should follow pension accounting and reporting requirements. Therefore, the valuation of the liability was re-evaluated resulting in a slight adjustment and the footnote disclosures were revised.

IT RECOMMENDATIONS

As part of our 2007 audit, we evaluated the information technology controls as they relate to financially significant applications. Our procedures primarily focused on documenting and evaluating general computer controls, including:

- Logical access to data and applications
- Change and incident management
- Systems development and deployment
- Data backup and recovery

CURRENT YEAR COMMENTS (cont.)

IT RECOMMENDATIONS (cont.)

The following points contain suggestions for strengthening internal controls in these areas:

- A formal software acquisition policy should be developed that outlines the process and requirements for acquiring any new software. A system development lifecycle should be developed to facilitate any internal software development projects.
- A formal change management procedure should be in place for all program changes, system changes, and maintenance. The process should include a method for tracking changes (including approval and testing). Additionally a standard form (paper or electronic) should be used to request, record and facilitate all changes.
- Access rights, including admin rights, should be reviewed at least once a year by management to ensure users don't have access beyond their job responsibilities and segregation of duties is maintained. In addition a standard form (paper or electronic) should be used to facilitate all change in employee access.
- Only a select few personnel should have access to the Server room. IT and/or management should review the list of those with access to the server room at least annually. In addition the Agency should consider installing heat and water detection systems as well as a fire suppression system to protect the servers from damage.

UPDATE ON PRIOR YEAR COMMENTS

COAL INVENTORY

Starting in fiscal year 2006, the Agency hired an outside engineering firm, Burgess & Niple, Inc. to perform a physical inventory of the coal pile at year end to compare to the utility's perpetual inventory system. In fiscal year 2007, this physical count resulted in a negative adjustment to coal inventory of approximately \$160,500.

We recommend management review the perpetual inventory procedures for greater accuracy to ensure an adjustment this large does not occur in the future.

Status at 6/30/08

Again for fiscal year 2008 there was an adjustment to the coal inventory of \$180,000 or almost 2,700 tons. Although this is significant in comparison to the year end inventory it represents less than 1.5% of the total coal used during the year. We recommend that management continue to monitor the coal inventory process and the year end adjustments to ensure any significant changes are investigated in a timely manner.

EXCESS RESTRICTED RESOURCES

The revenue bond resolutions require the Agency to maintain certain segregated investments for the payment of operating costs, debt service and reserves. At June 30, 2005 we noted that these accounts were overfunded by almost \$2 million dollars.

Board of Commissioners
Michigan South Central Power Agency

August 29, 2008
Page 5

UPDATE ON PRIOR YEAR COMMENTS (cont.)

EXCESS RESTRICTED RESOURCES (cont.)

Status at 6/30/08

As of June 30, 2008 these accounts continue to be overfunded, primarily the contingent reserve fund. Management may wish to maintain these account balances for investment earnings or diversification purposes, but we noted that the excess funds are not restricted by the bond resolutions and can be utilized as the Agency sees fit.

CLOSING COMMENT

We thank your accounting and office staff for their cooperation and assistance during our audit. As always, the staff gave us their undivided attention while we were at the Agency office. If you have any questions concerning these comments or recommendations, please contact Jodi Dobson or Russ Hissom.

Sincerely,

VIRCHOW, KRAUSE & COMPANY, LLP

Virchow, Krause & Company, LLP

RH/JLD/jas